NSC Meeting on Senate Bill 812

3 December 1985 -- 1400

(Cabinet Room)

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The Director of Central Intelligence

Washington, D.C. 20505

National Intelligence Council

NIC 05827-85
2 December 1985

MEMORANDUM FOR: Deputy Director of Central Intelligence

FROM: [redacted] 25X1
Acting National Intelligence Officer for Economics

SUBJECT: NSC Meeting on Senate Bill 812

1. On Tuesday, 3 December, there will be a joint NSC-EPC meeting to determine the Administration's position on S. 812, the Financial Export Control Act, which would give the President powers to bar lending by US institutions to "controlled" countries. Note that the position paper (Attachment B) has been revised and contains one option supporting S. 812 and two options opposing it.

2. Senators Garn and Proxmire proposed S. 812 (Attachment A) as a way of preventing the Soviet Bloc from using funds borrowed in the United States to finance the transfer of technology or to fund other activities such as support for Nicaragua. The bill was introduced on 28 March as an amendment to the Export Administration Act; hearings will be held on 4 December.

3. In terms of substance, it would, of course, be impossible to stop US funds from flowing indirectly to the Bloc or convince countries in Western Europe to halt additional credits in any "non-emergency" situation. The Justice Department argues that provisions in the bill would allow the President to avoid excessive use of the International Emergency Economic Powers Act (IEEPA), invoked for the Nicaragua sanctions. Others within the Administration say that the President ought to have the power to take actions short of those under IEEPA if the situation warrants. The Secretaries of Treasury, State, and Commerce oppose the controls contained in S. 812, arguing that they would be ineffective, run counter to our aim of improving the dialogue with the USSR, and are inherently against our interests. Defense and NSC are in favor of some powers along the lines of S. 812, although not necessarily in the form provided in the bill. OMB is opposed to the bill but proposes that the Administration find ways of taking such actions short of legislation.

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SUBJECT: NSC Meeting on Senate Bill 812

4. Setting aside the above objections, CIA can make the point that this is an appropriate time to consider such powers because the Soviet Union will suffer a substantial decline in hard currency earnings over the next five years, and Western credits will be needed if Moscow is to maintain its purchases of Western machinery, equipment and technology. We might also want to question whether the bill should be targeted at additional areas such as those states that support terrorism.

5. The meeting on Tuesday will focus on three options.

1. Giving Administration support to S. 812 or an acceptable legislative alternative.

2. Saying the Administration is opposed to S. 812.

3. Saying that the Administration is opposed to S. 812 but will continue to monitor financial flows and assess the feasibility of future policy changes.

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Attachments:

A. Senate Bill 812
B. Memo and Attachment on Financial Export Control Act
C. Advanced Industrial Technologies in the USSR: Progress and Problems
D. USSR: The Role of Foreign Trade in the Economy
E. USSR: Implications of Reduced Oil Exports
F. Eastern Europe: Boom Market for Syndicated Lending

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By Mr. GARN (for himself and Mr. PROXMIRE):

S. 812. A bill to amend the Export Administration Act of 1979 to authorize controls of the export of capital from the United States; to the Committee on Banking, Housing, and Urban Affairs.

FINANCIAL EXPORT CONTROL ACT

● Mr. GARN. Mr. President, today I am introducing the Financial Export Control Act, a bill authorizing the President to control the transfer of money and other financial resources from the United States to countries against which we maintain national security export controls.

For the past 3 years the Congress has been reviewing the Export Administration Act in an effort to improve our ability to prevent the transfer of sensitive goods and technology to our adversaries. The Defense Department recently commissioned a private study of the impact of technology transfer on our defense spending. That study, which will soon be released, confirms what we have long feared, that technology transfer to the Soviet bloc costs us tens of billions of dollars annually in increased defense costs.

Mr. President, although a bargain in comparison with our development costs, the Soviets have to pay for the technology they obtain. It is unfortunate but true that the Soviets are successful in gathering Western technology with the help of people living in the Western democracies. But that help has to be bought. In fact, the Western high technology smuggler demands a premium price for everything he delivers, and he will not take payment in rubles. This means, Mr. President, that the Soviet ability to obtain the sensitive goods and technology from the West that are turned against us in Soviet weapon systems is directly related to their ability to obtain hard currency, Western currencies.

There are only a few ways that the Soviets can obtain hard currency. They can export to the West, but the quality of Soviet products is so low that export sales have been limited to exports of raw materials, such as gold and natural gas, and to arms exports.

The other way that the Soviets have in the past obtained what is for them very scarce Western currency is through loans from Western banks. This source largely dried up, however, over the inability of Poland and several other Soviet allies to pay their debts and the furor caused by the realization that Western banks were so deeply involved in lending to the Soviet bloc at the same time that these countries were brutally repressing their own citizens.

Lately, however, Western European banks have resumed their lending to the Soviet bloc. The level of lending reached $3 billion last year, a threefold increase over 1983. The only bright spot in this gloomy picture was the fact that U.S. banks were staying out. Now that, too, is ending. American banks are now falling over each other to get back into lending to the Warsaw Pact, and at terms far more favorable than what the Western Europeans were offering. Last year, while West German banks were making largely short-term loans to East Germany at rates 3 or 4 percentage points over the London Interbank offered rate [LIBOR], First Chicago Bank gave the East Germans a $75 million loan at only 1 point above LIBOR. The Western Europeans have since begun matching those terms.

Not to be outdone, however, New York's Citibank is currently syndicating a loan to East Germany in the amount of $500 million, at seven-eighths of a point above LIBOR or one-half point above the U.S. prime rate. This loan started out at a mere $150 million, but there was such enthusiasm for it from U.S. banks that the East Germans were persuaded to increase the amount. Moreover, this loan is for 7 years, with a built-in 3-year grace period.

Mr. President, the prime rate is currently at 10.5 percent, so the Citibank loan to East Germany, in today's terms, would be for a rate of 11 percent. I wonder whether any of my colleagues have any constituents that would like to borrow money at 11 percent. Do they have anyone who would like to buy a home at 11 percent, or obtain credit for farm improvements at 11 percent? Perhaps they have some constituent that would like to start or expand a business with an 11-percent loan, or make an export sale. They very well may have such people, but they are unlikely to find those kinds of loans being offered. Apparently, a family trying to buy a home, a farmer, a businessman in the United States cannot easily get such a rate, but the East Germans can.

What are the East Germans going to do with such a loan? Are they going to expand human freedoms, increase individual opportunity? No. Instead, the East Germans are going to use the money to buy Western high technology. They are concerned by the fact that their Communist economy is falling farther and farther behind the economy of West Germany—and it is worth adding that the East Germans came to Citibank because the West German banks were requiring human rights concessions for the granting of their loans.

The East Germans are also eager for Western technology because their Soviet masters are demanding more high technology imports from the East Germans in exchange for Soviet energy supplies. That is to say, although the loan is going to the East Germans, its benefits are going to the Soviets.

Mr. President, I am not sure how we can best deal with this problem, but I do know that we are making our export control task all the more difficult by lending our adversaries the money with which to obtain our technology. This is a practice that must stop. Our banks may make some profits from the loans, although their troubled East European loan portfolio casts some doubt on that. But whatever profit they may obtain is far short of the expense that it causes us to make up for Soviet bloc military advances made possible by Western technology. What would interest rates be for our people if we could safely decrease defense spending by tens of billions of dollars annually? We cannot make such cuts, however, as long as we are contributing so directly to Soviet bloc military advances.

I am offering this bill today for consideration by my colleagues in hopes that it will lead to an end to the practice of lending to our adversaries. This bill authorizes, but does not direct, the President to control transfers of capital to countries against which we maintain national security export controls, the Soviet bloc countries. The President would be given full discretionary authority so as to apply such controls in the manner most in keeping with our national interests.

The bill in its current form is a discussion draft. My colleagues may have some other ideas, and some changes may need to be made. Perhaps the problem can be solved without legislation, but I believe that the time has arrived to address this situation directly.

Mr. President, I would also like to mention to my colleagues that I do not intend to add this bill to current proposals to amend the Export Administration Act that are being considered here and in the House of Representatives in connection with the reauthorization of the Export Administration Act. This is a separate item of legislation.

Mr. President, I ask that the text of an article from the March 19, 1985, edition of the Wall Street Journal that details the recent Citibank loan, along with the text of the bill and a section-by-section analysis of the bill, be included in the RECORD at this point.

There being no objection, the material was ordered to be printed in the RECORD, as follows:

[From the Wall Street Journal, Mar. 19, 1985]

EAST GERMANS BENEFIT FROM U.S. BANK CREDITS THAT DON'T CALL FOR HUMAN-RIGHTS CONCESSIONS

(By Frederick Kempe)

EAST BERLIN.—American bankers' eager resumption of credits to East Germany is helping the country avoid human-rights concessions in its financial relationship with West Germany.

East Germany avoided a Polish-like financial crisis in 1982 and 1983 through two separate credits negotiated and guaranteed by Bonn and extended by West Germany banks. In return, East Germany ceased restrictions on West Germany visits to the East, and it also last year allowed 40,000 East Germans to emigrate to West Germany.

Western experts now believe that East Germany yielded the short-term human-rights concessions to pursue significant longer-term aims that would spare it from such a vulnerable political position again. It combined the West German credits with a strict austerity program and dramatic import reductions to considerably improve its economic performance and its image among international creditors, who now are competing to give the country money.

CHANGE OF COURSE

Bank of America, Manufacturers Hanover and Citicorp, who were refusing East Germany new credits a little more than a year ago, are managing with the bank of Tokyo a $150 million credit that has grown to $500 million largely due to U.S. banks' demand. The loan hasn't any political strings attached, and its terms are the best East Germany has seen since the Polish repayment crisis—⅞ percentage point over the London Interbank Offered Rate (Libor) or an option for ½ percentage point over the U.S. prime rate. It is to be repaid over seven years with a three year grace.

"It's all a political business," says Wolfgang Seiffert, economic adviser to the East German government until 1978, and now a professor in Kiel, West Germany. "The attempt of East Germany to get money from American and other banks is an effort to get western finances without liberalization measures. The money will give East Berlin a stronger hand for its political games with West Germany because it doesn't need Bonn's money as much anymore."

West German bankers also complain that the Americans have been driving prices down in their effort to get back into the East Germany lending market that they abandoned in 1981, when Poland cast a shadow over all of Eastern Europe.

Until last year, West German banks were extending the East Germans primarily commercial loans, usually to be repaid after one year at a rate three to four percentage points above Libor. However, East Germany extracted far better conditions from First National Bank of Chicago when it worked its way back into the market last year. First Chicago offered a $75 million club loan at only one percentage point above Libor, a rate that European banks thereafter were forced to match despite a feeling by many lending officers that the margin wasn't sufficient.

THE GROWING GAP

U.S. banks are injecting money into the East German economy at a critical time. East Germany considerably reduced imports over the past three years to achieve hard currency trade surpluses and to service debts, but it also dangerously reduced investment. The result was that the technology gap between it and its West European neighbors grew.

Western economists expect the next East German five-year plan, from 1986–1990, to include an ambitious investment program, particularly emphasizing purchases of Western technology.

This is partially a response to a Soviet ultimatum that Moscow is to get Western-quality goods in exchange for the raw materials it provides Eastern Europe, or Moscow will reduce the amounts provided. The Soviets warn that Soviet oil can simply be sold on Western markets and the proceeds used to buy more advanced Western products.

"The East Germans are the largest East European technology sluice and supplier for the Soviets," says Klaus Schroeder of the West German government-sponsored Institute for Science and Policy near Munich. "Soviet demands have put a large amount of pressure on the East Germans to modernize their industry."

GOOD PERFORMANCE

U.S. bankers argue that they have good reason to be wooing the East Germans. First, they say East Germany's economic performance is the best in Eastern Europe. Produced national income (basically, gross national product minus invoices) in 1964 rose by 5.5%, compared to 4.4% the year before. Net industrial production rose 8.5% against 4.6% in 1983. Industrial labor productivity increased 7.7% against 5.8% in 1983.

The bankers also cite a radical improvement in East Germany's external position. While East Germany's debt to Western banks of $10 billion once was worrying to the banks, they now place more emphasis on East Germany's buildup of deposits in Western banks to some $4.5 billion.

Some also argue that a double umbrella exists over East Germany. They say the Soviets wouldn't allow their most important economic ally to enter into repayment difficulties and hence would bail the East Germans out. The bankers are even more confident about a West German umbrella, following Bonn's financial intercession during East Germany's recent problems.

"The proof is in the pudding," one U.S. banker says. "East Germany is a solid bet. We have been aggressively adding to our exposure."

However, many Western experts believe the banks are making the sorts of errors they did when more than 400 lending institutions scrambled in the 1970s to do Polish business. They are competing to give East Germany even more cash than it is asking for, yet East German economic reporting remains imprecise. The bankers haven't any specific idea what East Germany intends to do with all the money, nor whether it can eventually earn the hard currency to repay the loans.

"Bankers learn very slowly and forget very quickly," says Mr. Schroeder, a former bank economist.

Says Mr. Seiffert, "The economic situation in East Germany has improved, and so no one should have great worries about giving the country credits, but the U.S. banks currently aren't being prudent enough and should only extend credits when linking them to specific projects or investment plans."

SECTION-BY-SECTION ANALYSIS OF THE FINANCIAL EXPORT CONTROL ACT

Section 1 gives the title of the legislation as the Financial Export Control Act.

Section 2 adds to the Export Administration Act of 1979 (EAA) a finding that loans and transfers of capital to the Soviet Bloc add to their ability to acquire sensitive goods and technology.

Section 3 adds to the EAA a statement of policy to restrict transfers of capital to controlled countries in order to further national security export control policies.

Section 4 adds to the EAA a new section 8A, authorizing the President, through the Secretary of the Treasury, to control transfers of capital to controlled countries, and directing the Secretary of the Treasury to conduct negotiations with other countries to obtain cooperation on any such controls imposed.

Section 5 is a conforming amendment, designating the Treasury Secretary as responsible for issuing licenses that may be required for capital transfers to controlled countries.

Section 6 authorizes the Secretary of the Treasury to enforce the controls on transfers of capital to controlled countries.

Section 7 is a conforming amendment to the reporting provisions of the EAA, requiring the Treasury Secretary to issue a report on capital controls, as part of the annual report on export controls submitted to the Congress by the Commerce Secretary.

Section 8 gives the Treasury Secretary the authority to issue regulations.

Section 9 contains definitions.

S. 812

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Financial Export Control Act".

SEC. 2. Section 2 of the Export Administration Act of 1979 is amended by adding at the end thereof the following:

"(10) Loans and other transfers of capital to the Soviet Union and its allies from public and commercial sources significantly increase the ability of those countries to obtain sensitive goods and technology, thereby damaging the security interests of the United States and its allies.".

SEC. 3. Section 3 of the Export Administration Act of 1979 is amended—

(1) in paragraph (2)(B), by striking out "and" after the semicolon;

(2) in paragraph (2)(C), by striking out the period and inserting in lieu thereof "; and "; and

(3) by adding at the end of paragraph (2) the following:

"(D) to restrict the export of capital, the extension of credit, the making of loans, or the transfer of financial resources to destinations to which exports are restricted in order to carry out the policy described in subparagraph (A) of this paragraph.".

SEC. 4. The Export Administration Act of 1979 is amended by inserting after section 8 the following new section:

"CAPITAL CONTROLS

"SEC. 8A. (a) AUTHORITY.—In order to carry out the policy set forth in section 3(2)(D) of this Act, the President may prohibit, curtail, monitor, or otherwise regulate the export or transfer, or participation in the export or transfer, of money or other financial assets, including the making of a loan or the extension of credit, to the government of any controlled country, or to any political subdivision thereof or any organization or association owned by or acting for or on behalf of such government or political subdivision thereof. The authority contained in this subsection shall be exercised by the Secretary of the Treasury, in consultation with the Secretary of Defense, the Secretary of Commerce, and such other departments and agencies as the Secretary of the Treasury shall consider appropriate.

"(b) NEGOTIATIONS WITH OTHER COUNTRIES.—The Secretary of the Treasury, in consultation with the Secretaries of State, Defense, and Commerce, and the heads of other appropriate departments and agencies, shall be responsible for conducting negotiations with other countries regarding their cooperation with controls imposed pursuant to subsection (a).".

SEC. 5. Section 10 of the Export Administration Act of 1979 is amended—

(1) in subsection (a)(1), by striking out "All export license applications" and inserting in lieu thereof "Except as provided in subsection (k), all export license applications";

(2) in subsection (j)(1), by inserting before the period ", except in the case of any license that may be required pursuant to section 8A of this Act, in which case the Secretary of the Treasury shall establish such procedures"; and

(3) by adding at the end thereof the following new subsection:

"(k)(1) Any export license applications required pursuant to section 8A of this Act shall be submitted by the applicant to the Secretary of the Treasury. All determinations with respect to any such application shall be made by the Secretary of the Treasury.

"(2) To the extent necessary, the Secretary of the Treasury shall seek information and recommendations from the Government departments and agencies concerned with aspects of the United States domestic and foreign policies and operations having an important bearing on the policy set forth in section 3(2)(D) of this Act.".

SEC. 6. Section 12 of the Export Administration Act of 1979 is amended—

(1) in the second sentence of subsection (c)(1), by inserting before the period the following: ", or in the case of information obtained with respect to section 8A of this Act, unless the Secretary of the Treasury so determines"; and

(2) in subsection (e), by striking out "The Secretary" and inserting in lieu thereof "Except with regard to the authority provided under section 8A(a), the Secretary".

SEC. 7. Section 14(a) of the Export Administration Act of 1979 is amended—

(1) by striking out "and" at the end of paragraph (19);

(2) by striking out the period at the end of paragraph (20) and inserting in lieu thereof "; and"; and

(3) by adding at the end thereof the following:

"(21) actions taken by the President and the Secretary of the Treasury to carry out the policies set forth in section 3(2)(D) of this Act, as described by the Secretary of the Treasury in a report submitted for inclusion as a part of the Secretary's annual report required by this section.".

SEC. 8. Section 15 of the Export Administration Act of 1979 is amended by inserting "and the Secretary of the Treasury" after "Secretary".

SEC. 9. Section 16 of the Export Administration Act of 1979 is amended—

(1) in paragraph (4) by striking out "and" after the semicolon;

(2) in paragraph (5) by striking out the period and inserting in lieu thereof a semicolon; and

(3) by adding at the end thereof the following:

"(6) the term 'extension of credit' includes loans, credit sales, the supplying of funds through the underwriting, distribution, or acquisition of securities, the making or assisting in the making of a direct placement, or otherwise participating in the offering, distribution, or acquisition of securities; and

"(7) the term 'loan' includes any type of credit, including credit extended in connection with a credit sale.".●

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NATIONAL SECURITY COUNCIL
WASHINGTON, D.C. 20506

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November 29, 1985

ATTACHMENT B

MEMORANDUM FOR

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Mr. Donald Gregg
Assistant to the Vice President
for National Security Affairs

Executive Secretary
Central Intelligence Agency

Mr. Nicholas Platt
Executive Secretary
Department of State

Mr. Alton Keel
Associate Director for National Security and International Affairs
Office of Management and Budget

Sherrie Cooksey
Executive Secretary
Department of the Treasury

Mr. Alfred H. Kingon
Cabinet Secretary

Colonel David R. Brown
Executive Secretary
Department of Defense

BG George Joulwan
Executive Assistant to the Chairman
Joint Chiefs of Staff

Mr. Stephen Galebach
Senior Special Assistant to the Attorney General
Department of Justice

Mrs. Helen Robbins
Executive Assistant to the Secretary
Department of Commerce

SUBJECT: Joint National Security Council/Economic Policy Council Meeting on Enrolled Bill S. 812 (S)

A National Security Council meeting has been scheduled for Tuesday, December 3, 1985, in the Cabinet Room to discuss Enrolled Bill S. 812. The agenda for the meeting is attached. This meeting is being jointly hosted with the Economic Policy Council. (S)

William F. Martin

William F. Martin
Executive Secretary

Attachments

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JOINT NATIONAL SECURITY COUNCIL/ ECONOMIC POLICY COUNCIL MEETING
Tuesday, December 3, 1985
Cabinet Room
2:00 p.m. - 3:00 p.m.

ENROLLED BILL S. 812

Agenda

I.	Introduction -- Background -- Issues for Decision	Robert C. McFarlane (5 minutes)
II.	Political Overview (Need for Additional Authority)	Secretary Shultz (5 minutes)
III.	Strategic Implications	Secretary Weinberger (5 minutes)
IV.	Financial Considerations	Secretary Baker (5 minutes)
V.	Status of IEEPA Authority	Attorney General Meese (5 minutes)
VI.	Soviet Bloc Dependence on the West	Director Casey (5 minutes)
VI.	Discussion	All participants (25 minutes)
VII.	Summary	Robert C. McFarlane (5 minutes)

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THE WHITE HOUSE

WASHINGTON

November 29, 1985

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MEMORANDUM FOR THE PRESIDENT

FROM: THE NATIONAL SECURITY COUNCIL AND THE ECONOMIC POLICY COUNCIL

SUBJECT: Financial Export Control Legislation

ISSUE

Should the Administration support S. 812, which would provide the President discretionary authority to monitor, and if necessary, restrict U.S. capital flows to the Soviet Bloc in non-emergency cases?

BACKGROUND

In March 1985, Senators Garn and Proxmire introduced S. 812, the "Financial Export Control Act," which would amend the Export Administration Act (EAA) to authorize the President to "prohibit, curtail, monitor, or otherwise regulate the export" of U.S. capital "to the government of any controlled country," which in practice would mean countries in the Soviet Bloc. The EAA now provides authority to control exports of goods and technology to the Soviet Bloc and other destinations.

Supporters of S. 812 argue, inter alia, that U.S. bank lending helps the Soviet Bloc import Western technology and finance activities that damage U.S. national security. The Department of Defense (DOD) cites as an example the timing of U.S. loans to East Germany with the announcement of an East German loan to Nicaragua.

The International Emergency Economic Powers Act (IEEPA) currently grants the President authority to restrict U.S. capital flows to the Soviet Bloc only in cases of emergencies threatening the national security, foreign policy, or economy of the United States. S. 812 is designed primarily to provide the President discretionary authority to restrict such flows in cases of non-emergencies as well. In addition, S. 812, read in conjunction with the Export Administration Act, could provide the President discretionary authority to restrict such flows to nations that support international terrorism or threaten regional stability.

The Senate Banking Committee is scheduled on December 4 to hold a second hearing on S. 812 and has invited the Departments of the Treasury and Defense to testify on the proposed legislation.

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POLICY OBJECTIVES

The Administration should consider this issue in the context of its impact on our national security, allied relations, and economic competitiveness. S. 812 would not require the restriction of U.S. bank lending to the Soviet Bloc. It would only provide the President discretionary authority to restrict such flows. However, one should evaluate S. 812 in terms of how actually using that discretionary authority to restrict such lending would affect our national security, allied relations, and economic competitiveness, particularly since the legislation would provide such authority to future administrations.

National security. How would restricting U.S. bank lending to the Soviet Bloc affect U.S. national security? The ability of the Soviet Bloc to generate hard currency through either exporting products or taking out loans enhances its ability to purchase both legal and illegal Western technology, which may damage U.S. national security and force the U.S. to devote more economic and budget resources to maintaining our technological lead. In addition, S. 812 supporters argue that increased U.S. bank lending to the Soviet Bloc has helped it finance activities in Central America and elsewhere that damage U.S. national security.

The Department of Defense argues that restricting U.S. bank lending to the Soviet Bloc would reduce its ability to obtain hard currency and thus purchase Western technology. S. 812 opponents argue that without the cooperation of our allies to restrict their lending, unilaterally restricting U.S. bank lending to the Soviet Bloc would probably not reduce the ability of the Soviet Bloc nations to obtain hard currency because other lenders would displace U.S. banks.

S. 812 opponents argue that continuing to focus our efforts on COCOM would be more productive than restricting U.S. bank lending in reducing the ability of the Soviet Bloc to purchase vital Western technology. S. 812 supporters suggest that the legislation would supplement COCOM by enabling the President to restrict the hard currency financing of activities, such as insurrections, as well as the financing of goods and technology covered by COCOM.

NSDDs 66, 75 and 169 define the linkage between commercial, foreign policy, and national security policies in U.S.-Soviet relations (see appendix). The Department of State believes that one element of a constructive relationship with the Soviet Union must be mutually beneficial nonstrategic trade. S. 812 might have an adverse effect on our efforts to encourage such trade and might be perceived as an attempt to engage in economic warfare, a policy which has been disavowed by this Administration. In addition, S. 812 might create confusion among our allies concerning the Administration's policy toward the Soviet Union and send signals that run directly counter to the message you created in Geneva.

Relations with our allies. How would attempting to restrict U.S. bank lending to the Soviet Bloc affect relations with our allies? In order to meet the stated objective of S. 812 to reduce "the ability of [Soviet Bloc] countries to obtain sensitive goods and technology," the total flow of hard currency from either Western loans to or imports from the Soviet Bloc would have to be restricted.

Any restriction of the total flow of hard currency to the Soviet Bloc would require the cooperation of foreign governments to lend less to the Soviet Bloc and not offset that reduced flow by importing more from the Soviet Bloc. Yet, our COCOM allies and other cooperating countries may resist further U.S. efforts to persuade them to restrict lending to the Soviet Bloc. For example, a determined effort in 1982 to persuade our major allies to agree to restrict official credits to the Soviet Bloc was less than fully successful.

Simply attempting to restrict the total flow of hard currency to the Soviet Bloc raises two risks to relations with our allies:

- Given the need to obtain the cooperation of foreign governments to restrict effectively the total flow of hard currency to the Soviet Bloc, attempting to restrict such flows could strain relations with our allies, particularly West European countries.

- Attempting to restrict the flow of U.S. bank lending from not only domestic banking offices, but also overseas branches and subsidiaries of U.S. banks, would raise the sensitive issue of extraterritoriality and would provoke strong European reaction similar to that resulting from the 1982 pipeline dispute. Very little current U.S. bank lending to the Soviet Bloc is done from domestic U.S. offices.

S. 812 opponents argue that even a reduction of the total flow of hard currency to the Soviet Bloc may not deter those countries from importing Western technology because they could reallocate hard currency from other uses, i.e., there would be some reduction of total imports, but not necessarily of vital technology. S. 812 supporters argue that reducing the total flow of hard currency to the Soviet Bloc by even a small amount could reduce its ability to import Western technology by requiring it to make more difficult choices between competing demands.

Economic competitiveness. How would attempting to restrict the flow of U.S. bank lending to the Soviet Bloc affect U.S. economic interests? There are at least two significant economic risks:

- Without the cooperation of foreign governments to restrict non-U.S. lending to the Soviet Bloc, unilaterally restricting U.S. bank lending to the Soviet Bloc would sharply reduce U.S. exports (including grain) to these countries, which last year totalled $7.2 billion, and might drive business to Western Europe and Japan.

- Cumulative restrictions on the outflow of U.S. capital might eventually lead to less foreign capital inflow into the U.S. and thus higher U.S. interest rates. Foreign investors find the U.S. financial markets attractive in part because of the absence of any U.S. exchange controls. Foreign investors could infer from legislation restricting U.S. bank lending to the Soviet Bloc a greater willingness by the U.S. to impose financial sanctions against residents of any country with which the U.S. differed. Such a perception might decrease the foreign demand for U.S. assets and raise U.S. interest rates.

POLICY OPTIONS

The Administration faces the issue of whether to support legislation providing the President discretionary authority to restrict U.S. capital flows to the Soviet Bloc in non-emergency cases. Because the IEEPA grants the President authority to restrict such flows only in emergency cases, a decision to support such legislation would suggest supporting S. 812 or working with its supporters to fashion an acceptable legislative alternative.

You should note that the December 3 NSC/EPC meeting represents the first NSC or EPC meeting on this issue. DOD strongly believes that you should have the benefit of hearing a discussion of this issue at a Cabinet level before making a decision.

Option 1: Support S. 812 or an acceptable legislative alternative, which would provide the President discretionary authority to restrict U.S. capital flows to the Soviet Bloc in non-emergency cases.

Advantages

- If such a policy succeeded in restricting the flow of total, not just U.S., capital to the Soviet Bloc, it could increase the economic costs to the Soviet Bloc of importing Western technology.

- Closer linkage between all aspects of foreign policy--diplomatic, commercial, and national security--would be assured. The security-minded objectives outlined in NSDDs 66, 75, and 169 would remain our policy.

- Credit sanctions against adversaries in non-emergency situations give the President greater latitude in responding to foreign policy challenges.

- o It could be useful to have authority to restrict U.S. capital flows in non-emergency cases, for example, where other countries support international terrorism or threaten regional stability. The Department of Justice suggests that supplementing the President's statutory authority with the authority provided by S. 812 would obviate the need to invoke IEEPA (with its notification requirements) in non-emergency cases.

Option 2: Oppose S. 812 and continue the current policy of not restricting arms-length non-concessional business, including U.S. bank lending to the Soviet Bloc.

Advantages

- o Supporting legislation that provides the President discretionary authority to restrict U.S. capital flows to the Soviet Bloc in non-emergency cases contradicts, particularly in the aftermath of the Reagan-Gorbachev summit, the President's policy of improving our dialogue with the Soviet Union and its allies. Part of this effort is to support the development of mutually beneficial nonstrategic trade.

- o If a President used the discretionary authority under S. 812 to restrict in non-emergency cases the flow of lending of U.S. banks, particularly that from overseas branches and subsidiaries, to the Soviet Bloc, it would probably strain relations with our allies, particularly West European countries.

- o Restricting the flow of U.S. bank lending *per se* to the Soviet Bloc could be ineffective because such lending could be displaced by lending from non-U.S. financial institutions. Moreover, even a reduction of the total flow of hard currency to the Soviet Bloc may not deter those countries from importing Western technology because they arguably could reallocate some foreign exchange from other uses, i.e., there would be some reduction of total imports, but not necessarily of vital technology.

- o Not restricting U.S. bank lending to the Soviet Bloc would support the competitiveness of U.S. firms selling non-strategic products to the Soviet Bloc.

- o Maintaining the confidence of foreign investors that the U.S. financial markets will remain open maintains the attractiveness of investing in U.S. assets and thus avoids raising U.S. interest rates.

Option 3: Indicate to Congressional supporters of S. 812 that the Administration opposes any legislation that would provide the President discretionary authority to restrict U.S. capital flows to the Soviet Bloc in non-emergency cases, but note that the Administration will continue to assess the implications of uncontrolled financial flows to the Soviet Bloc and the feasibility of any policy proposals.

Advantages

- Provides the same advantages as Option 2, but also expresses to Congressional supporters of S. 812 that the Administration continues to recognize the need to reduce the ability of the Soviet Bloc to import strategic Western technology.

DECISION

_______ Option 1: Support S. 812 or an acceptable legislative alternative, which would provide the President discretionary authority to restrict U.S. capital flows to the Soviet Bloc in non-emergency cases.

_______ Option 2: Oppose S. 812 and continue the current policy of not restricting arms-length non-concessional business, including U.S. bank lending to the Soviet Bloc.

_______ Option 3: Indicate to Congressional supporters of S. 812 that the Administration opposes any legislation that would provide the President discretionary authority to restrict U.S. capital flows to the Soviet Bloc in non-emergency cases, but note that the Administration will continue to assess the implications of uncontrolled financial flows to the Soviet Bloc and the feasibility of any policy proposals.

Appendix

Review of Past Presidential Policy

The latest statement regarding U.S.-Soviet commercial relations is contained in NSDD 169, "U.S.-USSR Joint Commercial Commission (JCC) Meetings" (May 17, 1985):

> "...The JCC meetings should be used to continue to express our serious concerns about Soviet human rights abuses and emigration policy. We must make it clear to the Soviets that their continued poor performance in these areas will have a serious negative effect on any effort to establish a more constructive bilateral relationship, including our economic and commercial relations."

Earlier, NSDD 75 on "U.S. Relations with the USSR" (January 17, 1983) specifically addressed commercial and financial issues:

"Economic Policy. U.S. policy on economic relations with the USSR must serve strategic and foreign policy interests as well as economic interests. In this contest, U.S. objectives are:

-- Above all, to ensure that East-West economic relations do not facilitate the Soviet military buildup.

-- To avoid subsidizing the Soviet economy or unduly easing the burden of Soviet resource allocation decisions, so as not to dilute pressures for structural change in the Soviet system.

-- To seek to minimize the potential for Soviet exercise of leverage on Western countries based on trade, energy supply, and financial relationships.

-- To permit mutually beneficial trade--without Western subsidies or the creation of Western dependence--with the USSR in non-strategic areas, such as grain."

NSDD 66, "East-West Economic Relations and Poland-related Sanctions," (November 29, 1982) defines specific objectives in East-West trade in the areas of credits, energy dependence, and exports of advanced technologies.

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USSR: The Role of Foreign Trade in the Economy

Foreign trade plays an important, albeit not critical, role in Soviet economic development. Although the Soviet economy is largely self-sufficient--purchases from abroad account for only about 10 percent of GNP--imports have helped Moscow improve consumption, boost productivity, remove industrial bottleneck, and modernize weapon systems. 25X1

East-Versus West as a Source of Imports

The USSR has traditionally favored its communist allies in its foreign trade.

- o About 65 percent of the USSR's machinery and equipment imports come from its Communist allies, mostly the East European countries.
- o These imports represent nearly half of all Soviet purchases from Communist countries. (See Figure 1)

Although East European machinery and equipment is often of lower quality than Western equipment, it is equal to or better than Soviet produced goods in many instances. The USSR also looks to Communist countries for manufactured consumer goods to supplement its own production. More than half of such imports--primarily clothing and furniture--are purchased in Eastern Europe. 25X1

While relying on Eastern Europe for much of its machinery and equipment needs, imports of Western technology and equipment have been essential to expand selected Soviet industries (e.g. chemicals and automobiles), despite difficulties in assimilation.

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- Imported chemical equipment in the 1970s was largely responsible for the output of ammonia, nitrogen fertilizer, and plastics doubling during this period.
- Construction of the Kama river truck plant, which is based almost exclusively on Western equipment and technology, has resulted in a roughly 100 percent increase in Soviet heavy truck output over the past decade. 25X1

Imports from the West also have played a key role in supporting the energy sector.

- The rapid construction of the Siberia-to-Western Europe gas pipeline would not have been possible without purchases of Western turbines, compressors, and pipe.
- Difficiencies in Soviet drilling, pumping, and exploration have promoted Moscow to purchase almost $20 billion in oil and gas equipment since 1975. 25X1

Imports of grain and other agricultural products have been the largest component of the USSR's western trade, however. A series of mediocre harvest during 1981-84 has pushed agricultural imports to record levels--with average annual purchases of some $10 billion during this period. Because of the limited ability of Communist countries to expand grain production, Moscow has had to rely almost entirely on Western countries to fill the gap between domestic output and requirements. 25X1

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Finally, in addition to contributing to specific industrial sectors and overall consumer well-being, acquisition of goods and technology from the West has enhanced Soviet military programs.

- o Access to specific technologies has permitted improvements in a number of weapon and military support systems.
- o Gains from trade, in general, have improved the efficiency of the economy and thereby reduced the burden of defense. 25X1

Foreign Trade Under Gorbachev

Since taking over as General Secretary in March, Gorbachev has made it clear that improved economic performance is his top priority. His plan focuses on modernizing the industrial base with more and better machinery--a strategy which could lead to an increased role in both Eastern Europe and the West. 25X1

Gorbachev is undoubtedly hoping for an increase in the flow of machinery from Eastern Europe. Since taking over, he has spoken about the need for broader and tighter intergration within CEMA. While such rhetoric is not new--the USSR has long advocated joint production and specialization within CEMA as a means of getting the East Europeans to cough-up more--Moscow seems more intent than ever on pressing its allies to make firm commitments on this issue. In this regard,

- An agreement signed by CEMA Prime Ministers in June pledged multilateral cooperation in designing and producing computer controlled systems.
- The agreement follows a recent call in PRAVDA for a 50-100 percent increase in the rate of growth in machine-building in CEMA countries during 1986-90. 25X1

Moscow is probably limited in just how much it can get from its allies. Because most East European countries are constrained by their own resource and economic difficulties, any sharp increase in machinery exports to the USSR would have to come at the expense of much needed domestic investment or sales to the West that bring in hard currency. Such a shift would risk undermining growth prospects throughout the area which could cause serious political problems. 25X1

The limited prospects for sharply boosting imports from Eastern Europe increases Moscow's incentive to trade with the West. In particular, Gorbachev probably will look to the West for imports of technology and equipment for selected sectors--energy and electronics, for example--where no good supply alternatives exist. Moreover, Moscow is presently in a good financial position to increase its purchases of Western machinery and equipment--at least in the near-term.

- With a relatively small debt and approximately $10 billion in assets in Western banks at yearend 1984, Moscow can easily obtain commercial credits to finance new purchases.

- o Most West European countries are also offering generous terms on government-backed credits in an effort to balance trade with the Soviets and spur their own economies. 25X1

Over the longer term, however, Moscow's financial position is much less certain--falling world prices for oil and declining domestic production could limit Soviet hard currency earning capacity. 25X1

Looking to the US Prospects for an expansion of Soviet purchases of US machinery and equipment appear good--albeit from the extremely low levels of recent years. The share of machinery and equipment orders going to the US doing first quarter 1985--10 percent--is substantially above last years 6 percent figure and, if maintained, would be the highest since 1979. (See figure 4) Moreover, the US-Soviet Joint Commerical Commission talks in May 1985 produced a Soviet pledge to

- o Try to do more business with US firms.
- o Put interested US firms on bidders lists.
- o Fully consider US proposals on their economic merit. 25X1

In this regard, we have seen an improved tenor in US-Soviet contract negotiations since the beginning of the year. The Soviets are currently discussing major deals with US firms for the sale of personal computers, energy equipment, and agricultural technology. Although these negotiations may be protracted, some signings appear likely. 25X1

Nevertheless, the vast majority of Soviet purchases from the US will continue to be agricultural products. Under the current long-term US-Soviet grain agreement (which expires in 1988), Moscow is committed to purchase a minimum of 8-9 million tons of grain per year, with a value of roughly $1 billion at current world prices. In poor crop years, Soviet purchases can be expected to be much larger. 25X1

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Central Intelligence Agency

ATTACHMENT E

Washington, D. C. 20505

DIRECTORATE OF INTELLIGENCE

4 September 1985

USSR: Implications of Reduced Oil Exports

Summary

Steadily declining oil production in the USSR apparently is preventing the Soviets from sustaining oil exports to the West. Soviet hard currency earnings from oil sales could decline substantially in 1985--possibly by as much as $3-4 billion, or over 10 percent of total hard currency export earnings. There are few signs that deliveries to Eastern Europe will be cut this year. If the Soviets continue to insulate Eastern Europe from oil disruptions, such a policy would be in stark contrast with the way the USSR handled a tight hard currency situation in 1981-82, when it eventually diverted oil deliveries from Eastern Europe to the West. [redacted] 25X1

Until very recently, Moscow has shown little sign of serious concern about its hard currency situation and we believe that the USSR is in a good position financially to handle the sharp decline in oil export earnings for the balance of 1985. If oil-export earnings remain depressed, however, Moscow probably will soon be forced to take more active measures, including possibly substantially increased borrowing, import cutbacks, and selling more gold. [redacted] 25X1

For the longer term, a continued decline in oil output--and reduced prospects for oil exports--will pose some difficult choices for the leadership. Indeed, Gorbachev is currently visiting the West Siberian oil and gas region probably to get a hands-on feel for the problem before finalizing investment choices for the coming five-year plan.

- There is little room for increased diversions of oil from the domestic economy in order to boost exports to the West,

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This memorandum was prepared by [redacted] 25X1
the National Issues Group of the Office of Soviet Analysis. 25X1
Comments and queries may be addressed to Chief, National Issues Group, SOVA [redacted] 25X1

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a maneuver the Soviets have used in recent years to sustain hard currency exports. Some slight savings from conservation and substitution programs will probably be realized, but the prospect for widespread savings is not bright. Thus, any major cutbacks in domestic oil allocation are likely to result in disruptive bottlenecks that would threaten Gorbachev's modernization program and perhaps cost him some political setback.

o Substantial cutbacks to Eastern Europe would result in serious economic difficulty to the economies of the region. Moscow will have to weigh carefully the attendant risk of economic instability and increased political tensions in the region that could stem from such cutbacks.

o The Soviets will need to continue importing sufficient quantities of grain and feedstuffs for the livestock program, and obtain the necessary industrial materials to prevent production bottlenecks. Increased imports of Western machinery also would seem necessary if Gorbachev's industrial renovation targets are to be met. 25X1

Facing these conditions, Moscow probably has no alternative but to accept some continuing decline in its oil exports to the West, while trying to reap whatever savings it can from the domestic economy and Eastern Europe. In our judgment, the Soviets will continue to import essential agricultural and industrial goods, and will have sufficient earnings to purchase Western machinery and technology that have the highest priority. But reduced hard currency availability could affect other planned imports of Western equipment at a time when the Soviet demand for such goods is likely to increase as a result of Gorbachev's modernization program. 25X1

Production Problems Grow

Soviet domestic oil output fell last year--by about 100,000 barrels per day (b/d)--the first time since World War II. On the basis of the oil industry's recent performance, including 14 months of declining output, we judge that production for 1985 will fall by over 300,000 b/d, or by about three percent. 25X1

Moscow is becoming increasingly concerned about its oil

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[redacted]

prospects. Major steps taken by the leadership to prevent declines in oil output have been to no avail. Last year, Moscow increased substantially investment in oil production, and earlier this year it overhauled the management of the oil sector. In early August, the Politburo decided on a 60 percent increase in construction and assembly work for the West Siberian oil and gas complex in the 1986-90 period. Such measures offer some prospect of slowing the longer-term decline in output, but can do little to improve oil output in the next year or two. The high level of concern was most recently reflected in Gorbachev's trip to West Siberia on 4 September, probably intended to give him a hands-on feeling for the problem before finalizing investment choices for the coming five-year plan. [redacted] 25X1

<u>Reduction in Oil Exports</u>

<u>The West</u>. Soviet oil exports to the West declined by about 40 percent during the first quarter this year compared with the same period in 1984. This was largely due to the harsh winter, which hampered oil production and sharply increased domestic oil consumption. Although few data are available, oil exports apparently rebounded during the second quarter--but not enough to offset the earlier declines, according to reporting from Western oil traders. [redacted] 25X1

Traditionally, the Soviets have substantially accelerated oil exports in the latter months of the year to offset low first-

[redacted] 25X1

quarter deliveries. According to Western journals with excellent contacts in the energy markets, however, oil traders expect the USSR to cut contract deliveries of oil by between one-third and one-half for an indefinite period beginning as early as September.[1] The Soviets have not made an official announcement, but, according to the reporting, have given some customers verbal notice several weeks in advance. Although similar press "warnings" have not been completely borne out in the past, the recent events are unusual.

- The Soviets generally provide only short notice on reductions or cancellations in contract deliveries. This time, they reportedly informed some customers several weeks ago, which suggests that the export difficulties may be major.

- When the USSR has claimed "force majeure"[2] in the past, the declarations were usually accompanied by statements that the disruptions in deliveries will be temporary or made up later. Such qualifications are notably absent this time around. 25X1

Some cutbacks are already taking place. Some customers of Soviet oil reported in the Western press that gas-oil deliveries to Western Europe were reduced in August. In addition, in the spot market--where the USSR makes roughly half of its sales to

[1] These cuts suggest that Moscow seriously underestimated the difficulty of turning around the slide in oil production that was evident in late 1984. The Soviet State Planning Committee (GOSPLAN) annually allocates approximate quantities for export to the West. These allocations, in turn, provide the basis for the spate of oil-export contract signings at the beginning of each year. 25X1

[2] Force majeure is a contract clause that exempts a party from fulfilling a contract due to extraordinary circumstances. 25X1

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the West--prices for Soviet oil in recent weeks have risen faster than the market as a whole, which probably reflects scarcities of Soviet oil available there. Such movements in prices in the past have preceded a substantial decline in Soviet oil sales. [redacted] 25X1

To our knowledge, the Soviets have not tried to boost oil imports from the Middle East for reexport to the West. During the first few months of the year, the reexports averaged about 300,000 b/d, about the same level as during all of last year. The Soviets in recent years have been able to increase oil delivieries from OPEC--particularly from Libya and Iraq in payment for arms purchases--as a way of increasing its overall exports to the West. [redacted] 25X1

__Eastern Europe__. Less information is available on Soviet oil exports to Eastern Europe, but there are only indications of some sporadic and small-scale cutbacks to Yugoslavia and Bulgaria. [redacted] 25X1

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Nevertheless, in our judgment, Moscow is doing its best to sustain oil deliveries to the region. The Soviets almost certainly would not make any substantial cutbacks in midyear, as this would be extremely disruptive on any centrally planned economy. Rather, any reduction in such deliveries--as was the

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case in 1982--would be made at the beginning of the following year, in concert with overall economic planning on an annual basis. The absence of grumbling from the East Europeans suggest that reductions in deliveries to the region are only marginal, and that no Soviet announcement has been made of a larger, more general cutback for next year. [redacted] 25X1

Implications for Hard Currency Earnings

Near Term. The expected decline in the volume of oil sold to the West, combined with lower world oil prices (which so far have averaged almost 10 percent below prices during January-August last year), could lead to a reduction in hard currency earnings of about $3-4 billion for 1985 as a whole. This would be a drop of 20 to 25 percent in earnings from oil sales, and a decline of more than 10 percent in the USSR's total hard currency earnings. [redacted] 25X1

Moscow cannot compensate for this drop by expanding other exports. Soviet earnings from natural gas sales to Western Europe are not expected to rise substantially this year. On average, Soviet gas prices have fallen somewhat, and the USSR has allowed at least one nation to postpone increases in purchases of Soviet gas. Other exports--including sales of metals, machinery, and weapons--face limited Western or LDC demand and, in some cases, constrained domestic availability. [redacted] 25X1

The USSR is probably in a fairly good financial position to

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[redacted]

cope with this year's oil export decline. At the end of March Soviet assets in Western banks stood at a comfortable $8.8 billion. So far, Moscow has shown few signs of serious concern about the need to compensate for a major drop in oil earnings.

- o Gold sales appear to to be up only slightly over the relatively low levels in 1984.
- o While Moscow has borrowed close to $1 billion from the West so far this year, most of this money apparently has been used to pay off earlier, higher-priced loans.
- o The Soviets turned down a French offer of approximately $500 million in credits for Astrakhan' and Tengiz energy development contracts, which were signed this spring. [redacted] 25X1 [redacted] 25X1

The expected erosion of its oil export earnings during the balance of 1985, however, could force Moscow to take more active measures in the near future. Options exercised in the past to deal with hard currency shortages include increases in net borrowing, cutbacks in imports, and larger gold sales. In response to a hard currency bind which developed in the first half of 1981, Moscow cut back hard currency allocations to the foreign-trade organizations in late 1981 and early 1982, causing delays in purchases and payments. In addition, the Soviets substantially increased short-term borrowing (mainly for grain purchases) and gold sales. [redacted] 25X1

On balance, we believe that the USSR is financially in a good position to satisfy most, if not all, of its import requirements from the West in 1985. Moscow will be helped this year by a better domestic grain crop and thus substantially

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reduced grain import requirements in the latter half of the year.[3] In addition, overall imports of Western industrial goods during the first quarter were lower than during the comparable period in 1984. It is not yet clear whether such imports have remained at reduced levels since then. While Soviet orders for machinery and equipment are up sharply during the first half of the year compared with last year, actual imports of machinery and equipment will not begin to rise until 1986 or beyond, given the usual lags in implementing contracts for large projects. Moreover, many of the deals are financed by long-term credits. [redacted] 25X1

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[redacted]

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[3] Moscow also should enjoy the benefits of a buyer's market this year in the international grain trade. World supplies are expected to be abundant, largely because of a bumper crop in the United States. [redacted] 25X1

[redacted] 25X1

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Longer Term. Beginning in the next year or so, the Soviets will likely have to deal with steadily declining export earnings from oil.

- o Domestic oil output continues to slide despite substantial increases in investment in the oil industry. Although the oil industry management has been overhauled, prospects for a turnaround in output are poor.
- o World oil prices continue to slide with little prospect for a reversal until the late 1980s.
- o Opportunities for boosting arms sales to OPEC nations--the traditional source for increased oil imports--are limited by the ability of these nations to absorb and pay for more arms. 25X1

Moscow has been hard pressed to compensate for the production decline by reduced domestic consumption. It has been trying to reduce the economy's use of oil for several years, primarily through energy conservation and programs for switching to the use of gas instead of oil in industry. There have been few signs so far that the USSR has, in fact, reduced its oil use. The Soviet press has been mum on successes in this area, suggesting that progress is dragging despite the leadership's emphasis on conservation. In addition, our analysis of the electric power industry--the main target of the gas-for-oil substitution programs--indicates that the oil "saved" at some power plants has been consumed anyway in offsetting major shortfalls in the supply of coal to other power plants and in producing above-plan amounts of electricity. 25X1

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Prospects for limiting demand during the next several years also are not bright. Gorbachev's program for retooling and installing more energy efficient equipment promises substantial savings, but only in the long run and after considerable expense. Over the next several years, the modernization program, vigorously pursued, will itself consume large quantities of fuel. Indeed, given Gorbachev's stated objectives, the mix of output is likely to become more rather than less energy intensive. 25X1

Implications for Eastern Europe

Moscow's allies would have considerable difficulty coping with a cutback in Soviet oil deliveries. Most of the countries in the region--plagued by sluggish export growth, large debt-service obligations, and uncertain borrowing prospects--do not have enough hard currency to purchase a substantial portion of their oil requirements on the international markets. Moreover, securing more oil through barter arrangements has been made more difficult because of a reluctance on the part of Third World countries to increase such deals. 25X1

Moscow repeatedly has told its allies that deliveries will not be cut in 1986-90. It made a similar promise in 1980, however, for the 1981-85 period, but cut deliveries anyway in 1982 when it needed to increase hard currency earnings. In aggregate, oil shipments to the region have not increased since

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The East Europeans survived the 1982 cutbacks without much difficulty because the region was reexporting some Soviet oil for hard currency. Cuts during 1986-90 would be much more troublesome as they likely would come out allocations for the domestic economies--at a time when Moscow will be putting more pressure on East Europe to increase production and delivery of energy-intensive goods (i.e. machinery and equipment). Balance-of-payments constraints would limit East European purchases of oil from hard currency sources, and reduced oil consumption in the region would affect economic productivity and growth. Lower growth would increase the likelihood of political instability in Eastern Europe and increased public resentment toward the Soviet Union. 25X1

Implications for Trade With the West

Moscow probably has little alternative but to accept some continuing decline in its oil exports to the West, while trying to reap whatever savings it can from the domestic economy and Eastern Europe. Faced with prospects for substantially reduced hard currency earnings, the Soviet leadership may be hard pressed to satisfy the entire range of import goals in the coming years. We believe, however, that the Soviets will continue to import sufficient quantities of grain and feedstuffs to keep the livestock program on track and obtain the industrial materials

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needed to reduce production bottlenecks. 25X1

The reduced availability of hard currency will probably affect imports of Western machinery and equipment the most. Barring a series of harvest failures and/or an unexpectedly rapid decline in oil production, Moscow should be able to earn enough hard currency through 1990 to purchase Western equipment that has the highest priority--equipment needed to develop oil and gas reserves at Astrakhan' and Tengiz, for example. But any cutback in imports of other Western machinery and technology would be occurring at a time when Soviet demand for such goods is increasing as a result of Gorbachev's modernization program. A less conservative borrowing policy could allow Moscow greater leeway in setting the level of these imports. 25X1

Changes in Soviet purchasing strategy may provide early indication of how the Soviets are assessing their prospects for oil production and hard currency exports. Specific indicators might include:

- Scaling back, stalling, and/or cancelling project negotiations now underway.
- Insistence that countertrade arrangements be included for all but the highest priority purchases.
- Greater concentration on domestic projects oriented toward supplying the export market when negotiating purchases from the West. 25X1

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ATTACHMENT F

Eastern Europe: Boom Market for Syndicated Lending [redacted]

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East European borrowing from Western banks has rebounded sharply this year. The region raised $2.8 billion in syndicated loans on increasingly favorable terms in the first 10 months of 1985—a sharp turnaround from the early 1980s when bankers slashed lending to the East. Japanese and Arab banks have played a leading role in new lending, while the importance of US and West European banks has fallen. Lenders have become more inclined toward Eastern Europe because of improved hard currency trade performance in the region over the past two years and a lack of comparably attractive investments elsewhere. Borrowers have taken advantage of favorable loan terms to restructure debt, build reserves, and cover shortfalls in hard currency earnings this year. [redacted]

Widening Circle of Borrowers

The number of East European countries returning to the syndicated market has grown quickly this year, and many of the loans have been oversubscribed.[1]

- East Germany secured a $500 million loan in March; in June it obtained a consortium loan for $600 million.
- Hungary in June tapped Western banks for the bulk of an $800 million World Bank cofinanced loan and Japanese banks for an additional $400 million since January.
- Bulgaria borrowed $200 million in July and $120 million in October.
- Czechoslovakia borrowed $100 million from a Western bank consortium in July.
- Four commercial banks extended an $80 million bridge loan to Romania in May, and, most recently, a group of Romania's leading creditor banks agreed to try to syndicate a $167 million loan.

Only Yugoslavia and Poland, which still require debt reschedulings, remain shut out of the syndicated loan market. [redacted] 25X1

Japanese and, to a lesser extent, Arab banks have played a prominent role in the upswing in new lending. Japanese banks, looking to diversify their loan portfolios, have taken the lead or jointly managed 41 percent of the loans to Eastern Europe this year, as compared with 18 percent in 1979. 25X1 According to West European bankers, increased competition from Japanese banks in the lending market has pushed down interest rates on loans to Eastern Europe. In contrast, US banks have managed 15 percent of this year's loans to the East, down from 20 percent in 1979. 25X1 This parallels the decline in overall US exposure to Eastern Europe. Many US banks that have managed recent loans to the region have been mainly interested in earning the management fees and have tried to sell off their portions of the loans quickly to limit exposure. [redacted]

Western Bank Motives

The lack of comparably attractive lending opportunities elsewhere largely explains the willingness, and, in some cases, even eagerness of Western banks to resume lending to Eastern Europe. The financial positions of East Germany, Hungary,

[1] Oversubscription occurs when participating banks offer funds in excess of the original loan amount. [redacted]

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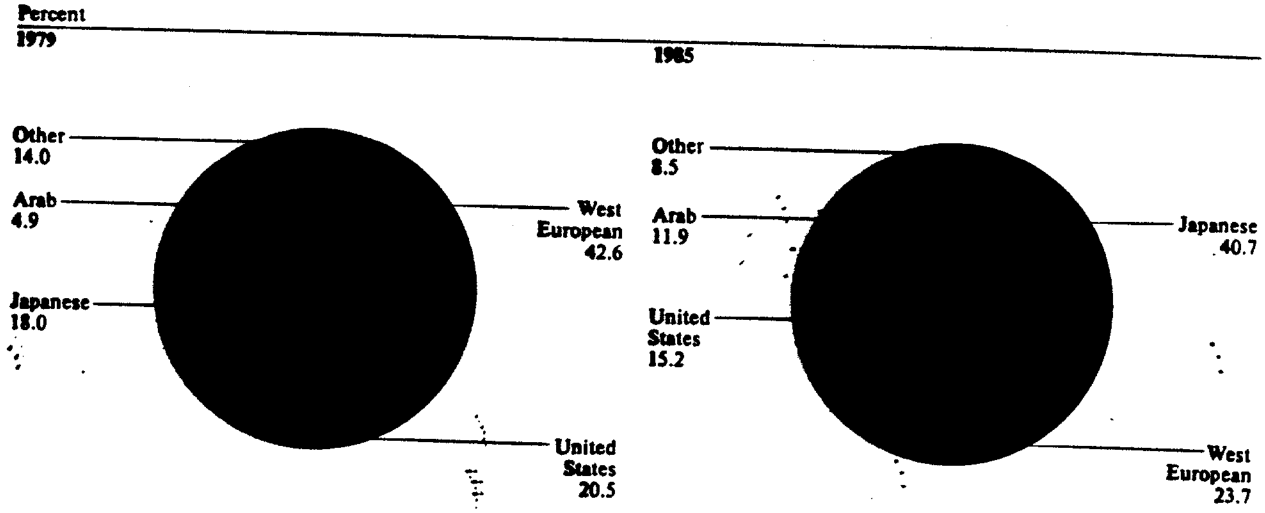
Management of Syndicated Loans to Eastern Europe, 1979 and 1985



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Bulgaria, and Czechoslovakia seem relatively more secure than those of many LDCs, especially in Latin America, where bankers feel overexposed. As a result, not only has the absolute amount of Eastern Europe's borrowing increased, but also its share of bank lending to countries outside the OECD—13 percent so far this year, as compared with 6 percent in 1976 and 10.5 percent in 1979.

Eastern Europe's hard currency trade surpluses in 1983-84 and some easing of East-West tensions have been the major factors encouraging bankers to look more favorably on the region. The East European borrowers have also substantially cut their debt since 1980, and, except for Romania, they have avoided rescheduling. Having made deep cuts in their East European exposure in 1981-83, banks now feel they have elbowroom to respond to loan requests from the more creditworthy countries. Some bankers—particularly in Western Europe and Japan—believe East European imports from the West will rise with the launching of new five-year economic plans for 1986-90, and they want to reestablish ties to the better credit risks.

Western banks have been particularly receptive to loan requests from East Germany and Hungary for additional reasons. East Germany, besides running sizable trade surpluses, boasts the strongest record of economic growth in Eastern Europe since 1982. Banks also value the West German umbrella for East Berlin, which Bonn demonstrated by guaranteeing two large West German bank loans during East Germany's liquidity squeeze. Finally, banks have found East Berlin a lucrative loan market because of the regime's acceptance of relatively high interest rates—recent loans have carried higher spreads over LIBOR than those for most other Bloc countries. The East Germans apparently prefer to have their loans oversubscribed at higher interest rates than to obtain the most favorable terms.

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In Hungary's case, bankers are counting strongly on Budapest's reform program to improve the efficiency and competitiveness of the economy. Hungary's good relationship with the IMF—which lent it nearly $1 billion in 1982-84—has added to

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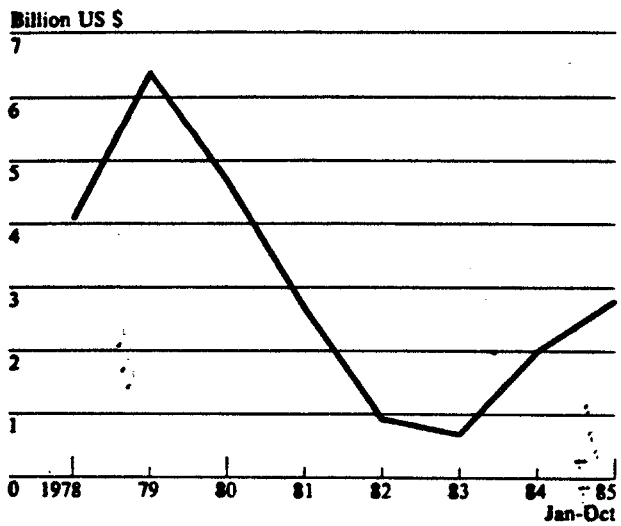
Syndicated Loans to Eastern Europe, 1978-85



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banker confidence. Moreover, banks have been eager to participate in World Bank cofinancing loans because they believe that Bank involvement guarantees that the loans are exempt from rescheduling should Budapest run into repayment problems. Japanese banks have been particularly attracted by the apparent security of these deals.

In Romania's case, however, new lending has been less than voluntary. Recent loans have stemmed largely from the bankers' desire to avoid another round of reschedulings. Disappointing export performance earlier this year seriously reduced Romania's foreign exchange reserves. Leading creditor banks concluded that Bucharest needed a major loan to cover large payments due in October under its rescheduling agreements.

Reasons for Borrowings

The East Europeans initially used the borrowings to repair some of the damage to their financial positions caused by the credit crunch. They took advantage of the longer maturities and lower interest rates to replace more expensive short-term debt accumulated in 1982-83. Borrowers also used the funds to boost reserves and build financial cushions against another cutback in lending to the region. East Germany and Czechoslovakia returned to the loan market to reestablish their credit ratings. For example, East Germany continued to raise new credits even though it had not drawn down all its previous borrowings and sought oversubscribed loans as proof of its financial strength. In contrast, the more recent borrowing initiatives by Hungary, Bulgaria, and Romania have resulted from shortfalls in hard currency earnings caused by poor trade performance this year. 25X1

Outlook

The borrowing trend is likely to continue, at least in the short run. Even countries with no immediate plans to draw down the funds will probably continue to exploit the continued shortage of lower risk LDC borrowers. In addition, some East European 25X1 countries may plan more borrowings to finance an increase in Western imports as they enter the new cycle of five-year plans. Some countries may see the need to import more capital goods to redress import cutbacks in the early 1980s and meet modernization requirements resulting from Soviet pressure to improve the quality of exports to the USSR. 25X1

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Still, an extended downturn in the region's economic health or deterioration in East-West relations could reverse the trend. While this year's slump apparently has not alarmed banks, lenders—and even borrowers—may become reluctant if trade performance continues to slide. The current enthusiasm among bankers for Eastern Europe may cool when it becomes apparent that these countries have done little to produce the sustained growth in exports needed to pay for more imports. Failures by Poland, Romania, and Yugoslavia to meet obliga- 25X1 tions under rescheduling agreements might sour some bankers on the entire region, but such a spillover seems much less likely than in 1981. A more serious threat to Eastern Europe's ability to obtain new loans might result from a reemergence of severe payments problems in the LDCs.

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Eastern Europe: Selected Major Loans in 1985

	Date	Million US $	Terms	Comment
East Germany	March 1985	500	7 years at LIBOR plus 0.875 point	Oversubscribed from $150 million.
	June 1985	600	8 years at LIBOR plus 0.75 on $520 million, US Prime plus 3/8 on $80 million	Oversubscribed from $20 million.
Hungary	January 1985	250	12 years at 11.2 percent fixed	From Japanese banks, which have extended an additional $150 million in smaller loans.
	June 1985	800	8 to 12 years at LIBOR plus 0.75	World Bank cofinanced loan.
Bulgaria	July 1985	200	4 years at LIBOR plus 0.375, 3 years at LIBOR plus 0.5	Oversubscribed from $100 million.
	October 1985	120	5 years at LIBOR plus 0.375	
Czechoslovakia	July 1985	100	2 years at LIBOR plus 0.25, 6 years at LIBOR plus 0.375	
Romania	May 1985	80	5 months	To cover payments on rescheduled debt.

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